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China's Second-Stage Agricultural Reforms: The Problems of Success

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An Intelligence Assessment

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January 1986*

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An Intelligence Assessment

This paper was prepared by [redacted]
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**China's Second-Stage
Agricultural Reforms:
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Key Judgments

*Information available
as of 23 December 1985
was used in this report.*

In January 1985, China launched its second-stage agricultural reforms to cope with problems created by the reforms initiated in 1978. Six consecutive years of bumper harvests:

- Placed a drain on the state budget because of grain and cotton price subsidies.
- Taxed an already inadequate state transportation system.
- Left large quantities of unwanted low-quality goods stockpiled in the countryside.

The second-stage reforms attempted to remedy these problems by moving toward an even more market-oriented agricultural economy. Peasants now sign contracts with the state to sell grain, cotton, and oilseeds at negotiated prices. Noncontract production of these commodities is sold on the open market with the government guaranteeing a price. Fruit, vegetables, and meat are no longer purchased by the state, and price is determined solely by the market. Rural industry is being promoted to absorb some of the excess labor created by increasingly efficient agricultural production and to ease transportation problems.

We believe Beijing judges these policies in their first year to have been generally successful. On the plus side, the second-stage reforms have succeeded in:

- Reducing the drain on the state budget.
- Moving excess labor into industry.
- Continuing to increase the gross value of agricultural output.
- Increasing peasant incomes and the rural standard of living.

The second-stage reforms have not worked entirely as Beijing expected, however. Peasants were quick to plant more profitable crops, such as oilseeds and vegetables, and grain production fell as a result. The inflation that followed the deregulation of food prices was more serious than Chinese officials anticipated. State vegetable and meat markets are having difficulty competing with the free markets. Beijing is finding it harder than expected to enforce agricultural guidelines on a peasantry increasingly comfortable in a more market-oriented environment.

Rural finance was a particularly volatile issue in the early months of the new reforms. Efforts to control loans for rural industry led to a credit crunch in April that left many state enterprises short of operating capital. This situation seems to have eased.

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The successes and problems have left both policymakers and local officials struggling to adapt to the state's new role in agriculture. Advocates of reform realize that success depends on decentralization of authority, but they are concerned about the negative side effects and are feeling the criticism of conservative critics. In his speech to the party conference in September, Politburo member Chen Yun charged that the reforms undercut the party's authority in the countryside and were threatening grain production.

Low-level officials, in particular, have been adversely affected by the second-stage reforms. Their prestige has been reduced along with their power. As a result, many have held back on implementing the program or seized on the numerous opportunities it provides to line their pockets.

In the coming year, we expect Beijing to fine-tune current policy rather than undertake any initiatives. We believe Chinese agriculture will grow by 6 percent this year and that per capita consumption of rural residents will increase by 4 or 5 percent. Key problems must be addressed, however, if the success of recent years is to continue:

- A policy must be developed that ensures increasing grain production without discouraging other agricultural production.
- Food-price inflation must be controlled without increasing state food subsidies.
- The conservative opposition to reform must remain contained.
- Beijing must bring low-level officials into line.

We expect an increase in grain output in 1986 as Beijing uses various incentives to rekindle peasant interest in grain production. Also, Beijing's fine-tuning will probably stabilize the rural economy somewhat and may help mollify party conservatives who have criticized reform.

The success of China's agricultural reforms makes it less likely that China will be a market for US agricultural products. China will be looking to the United States for agricultural technology, but we do not expect China to make any major purchases of US agricultural commodities any time soon. Indeed, as agricultural reform continues, China may even compete with the United States in some markets, as it did last year in corn.

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China's Second-Stage Agricultural Reforms: The Problems of Success

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The Need for More Agricultural Reform

For the past few years, China's leaders have been using agriculture as a testing ground for a series of pragmatic economic policies that are transforming the entire economy. The main thrust of this program—the peasant responsibility system—was to make peasants more responsible for their own production (see inset). In 1985, Beijing introduced the “second-stage agricultural reform,” touting it as a preordained step in its expansion plans for the rural sector. We believe, however, that China was forced to take action sooner than expected because of the overwhelming success of earlier reforms (see figure 1).

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Six consecutive years of bumper harvests and an unprecedented overabundance of farm goods presented policymakers with a new set of problems to discuss at the Third Plenum in October 1984. One of the most serious problems, from the viewpoint of the Chinese leadership, was the drain the burgeoning agricultural sector was placing on the state budget. According to a Chinese press report, in 1984 state expenditures grew by nearly 11 percent, largely because of increased grain and cotton price subsidies. State procurement policies had also failed to adequately reward product quality, so peasants produced low-value crops that required a minimum of investment. The problem was compounded when consumers, with their increasing disposable income, quickly purchased the limited supplies of high-quality goods, while the stockpiles of less palatable goods became ever larger. Also, the state-controlled transportation system lacked the capacity to move surpluses to areas where they could be better utilized.

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The second stage of reforms, presented in Central Document No. 1 of 1985, was an attempt to solve the farm economy's marketing and budget problems by abolishing the state monopoly purchase of agricultural commodities. Beijing's planners envisioned integrating peasant initiative, a streamlined bureaucracy, and a modified agricultural control structure to create

The Peasant Responsibility System

The peasant responsibility system, which increased peasant incentive by linking income to decisionmaking responsibility and production, became official in December 1978 during the party's Third Plenary session of the 11th Central Committee. Reformers recognized that the communal work structure failed to reward diligent labor because peasant income was not directly linked to output and peasants had little say in collective decisions. The fact that food production was barely keeping pace with population increases was a probable factor in the decision to implement more pragmatic policies. Also, production costs had risen, and, in the absence of price increases, farm incomes had stagnated. These new policies brought several important changes to the Chinese countryside:

- *Communes were dismantled. Individuals and families were allowed to rent farmland and to make their own production decisions.*
- *Farmland was rented for 15-year periods, encouraging peasants to invest in the land.*
- *Procurement prices were adjusted upward, so farmers had more incentive to increase production. Such incentives brought an increase in willingness among peasants to invest their time and resources in agricultural production and were largely responsible for the 50-percent increase in rural production between 1978 and 1984.*

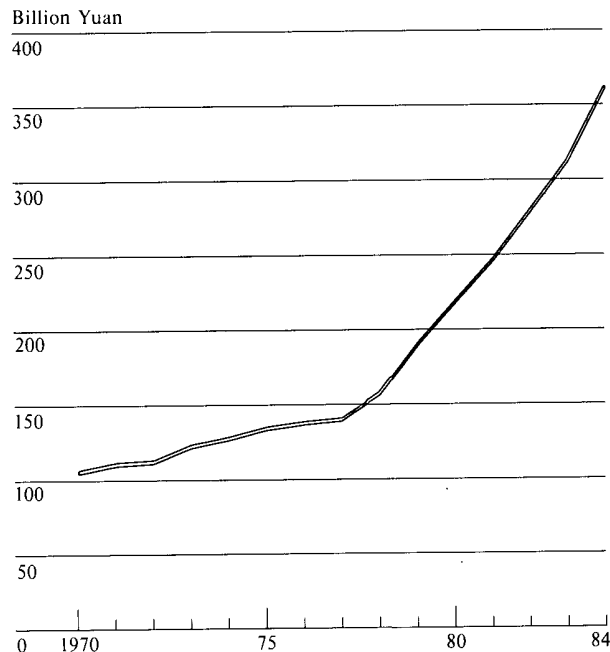
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a “commodity” agricultural economy with large elements of free market circulation. The reforms have several important elements:

- Peasants sign contracts to sell part of their grain, cotton, and oilseed harvests to state commercial departments at negotiated prices.

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Figure 1
China: Gross Value of Agricultural
Output, 1970-84



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- Noncontract grain, cotton, and oilseed production are sold on the open market. The government will now purchase these products only if the market price falls below the procurement price.
- The state will no longer purchase nonstaple products such as vegetables, fruit, and meat. Supply and demand forces will set the prices for these commodities.
- Rural industrial development is now promoted. Rural businesses are to absorb surplus labor being forced out of the increasingly efficient agricultural sector.

The Impact of Reform on the Market and Prices

In our judgment, the abolition of state-set prices and monopoly purchases of meat, fruit, and vegetables has caused larger price increases than Beijing expected.

In various press reports last spring, leaders expressed their belief that prices would go up and then slide back to near their original levels as supplies increased to match demand. In actuality, dramatic inflation occurred after price decontrol, and, although prices appear to be falling some, they are still above their original levels. However, the current higher prices better reflect an equilibrium between the prices consumers are willing to pay and the prices at which peasants can profitably produce farm goods.

increases in consumer prices occurred throughout the country. By early May 1985, within a few weeks of price decontrol, a local press account indicated that average Beijing food prices had increased by 30 percent. In the following months, the prices of some local favorites, such as lean pork, beef, and some varieties of fish, had doubled or tripled. In Shanghai, Guangzhou, and other major cities, press reports indicate the story of increasing food prices has been the same (see inset).

Local and provincial governments have been using various methods to fight food price inflation and to compete with free market vendors. State-controlled food markets have been directed to sell merchandise at below-market prices. After trying to hold the line on prices, however, the state trading system in some areas raised prices because middlemen were buying the grain from state stores and reselling it at higher prices on the open market. State vegetable and meat markets are also having difficulty competing with free market vendors, who offer higher quality produce. Some government stores have responded by distributing lower quality goods to match their lower price structure. Local cadre are reassigning some market workers to other responsibilities to try to cut their excessive overhead costs. A recent press report from Guangdong states that over 400 state markets have been shut down this year because of free market competition.

Attempts by local and provincial governments to use subsidies to soften the effect of rapid price rises seem to be creating as many problems as they solve. US

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Food-Price Inflation in Two Chinese Cities

Beijing

In Beijing, meat has increased 30 percent. Vegetable prices soared as well and are not expected to settle at reasonable levels for some time. When price controls on meat and vegetables were first lifted, the retail price index rose by 9.3 percent, which is an all-time high.

— UPI quoting Peking Review
12 December 1985

Guangzhou

Prices of agricultural and sideline produce have gone up to varying degrees, officials of the city vegetable company said. Compared with last year, the price of pork rose 72.13 percent, and vegetables as a whole went up 46.4 percent.

— Xinhua
16 August 1985

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Embassy and Chinese press reports note rising discontent over inflation and unequal distribution of subsidies in many major cities.¹ As local governments move to relieve food-cost burdens on workers in one sector of the urban economy, other workers and students have complained that the subsidies are discriminatory and have demanded equal treatment. In many areas, a pattern is developing where prices are allowed to rise, a subsidy or wage increase is granted, and then prices rise again. Some urban residents have indicated they would prefer not receiving any more subsidies to avoid what they perceive to be an inflationary spiral. We believe that attempts to counterbalance price

¹ Inflation was a major complaint of students who demonstrated in Beijing and other Chinese cities during September and October 1985. "Urban peasant" protests in Tianjin and Yunnan were blamed on popular displeasure over the unfair distribution of food subsidies.

increases by subsidizing incomes are in fact exacerbating inflation, putting new pressures on an already strained budget, and endangering the economic and political viability of the reforms.

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Changing Rural Production

Although China's peasants reacted hesitantly to the initial reform policies, we believe they quickly grasped the implications of the new reforms and the opportunities available to them, and are using the new reforms to their best individual economic advantage. One of the most significant changes has been a shift away from traditional grain production to cash and industrial crops.

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Although Beijing planned for some movement out of grain production with the implementation of the second-stage reform, party leaders at all levels have recently expressed concern about the "malaise in peasant attitudes" toward grain production. In August, the Chinese press reported that farmers would harvest 3.3 million fewer hectares of grain in 1985—a reduction of 3 percent—as croplands are used to produce more profitable crops (see figure 2). Anticipating lower profit margins for grain, peasants are using lower levels of production inputs such as fertilizer and labor. In addition, press reports indicate that, as profit margins fall and workers leave agricultural production, it is becoming unprofitable to produce on marginal land, and these areas are occasionally being allowed to lie fallow. As a result, we expect 1985 grain output will be 7 to 8 percent below 1984 levels (final figures are usually released in March).

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Moreover, with the new grain procurement system, peasants apparently feel less obligated to follow state guidelines on grain production. Early last year, the Chinese press reported that some peasants delayed signing grain contracts in the hope that prices would rise. An Embassy report stated that in Hunan peasants are hesitant to fulfill state contracts because of low procurement prices, preferring instead to sell their grain on the open market or to feed it to livestock. Unfulfilled contracts could create a poor legal precedent for future state-peasant relations and could mean

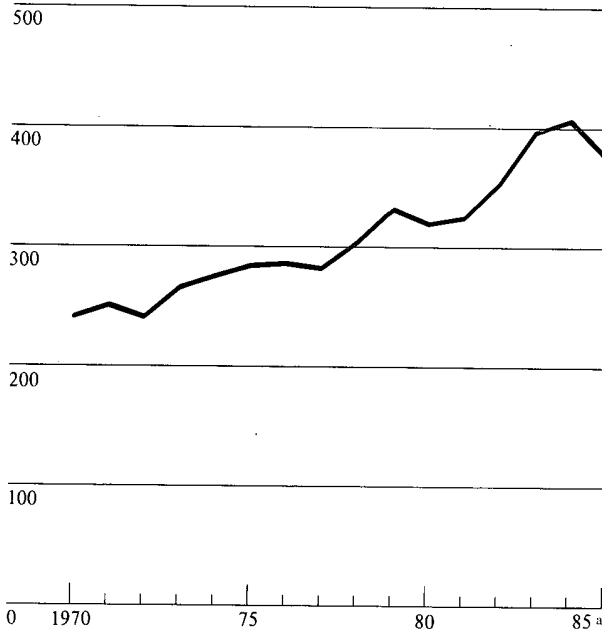
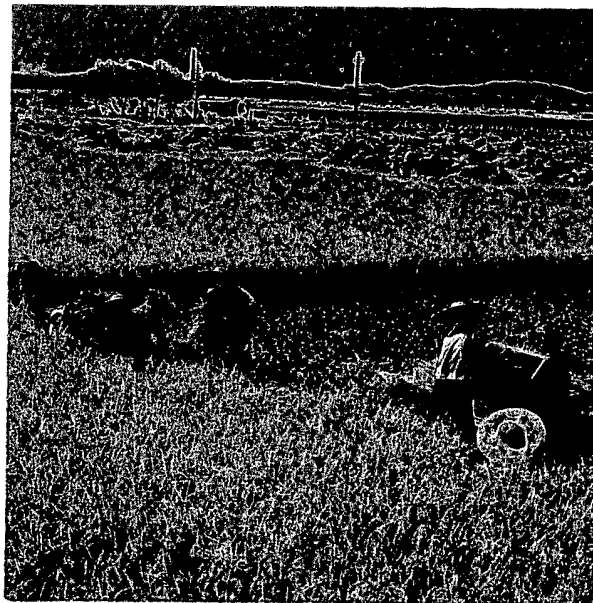
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Figure 2
China: Grain Production,
1970-85

Million metric tons

^a Estimate.

Grain output will decline an estimated 7 percent in 1985 after six consecutive years of record harvests.

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economic reform and the current lack of state control. Chen's clear implication is that even the past successes in grain production may be jeopardized if reform is too rapid, or if central planning is abolished in favor of market regulation.

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The production levels of nongrain crops, on the other hand, are continuing to increase as producers adjust their production according to changing market signals. China expects 1985 oilseed output to be up by more than 30 percent. Cotton producers have side-stepped state quotas and overplanted their cotton acreage in expectation that the state would continue to purchase all of their production. Higher meat and produce prices have brought about a rapid improvement in the quantity and quality of these products available on the market. According to USDA reports, red meat production increased by 16 percent in the first six months of 1985 over the same period in 1984 and milk output by 33 percent. Poultry and egg production have each increased by over 40 percent. Fish production and other specialized agricultural industries are also increasing in size and number.

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that in some areas the state will have trouble fulfilling its procurement quotas. As of 1 December, for example, state grain purchasers in Henan Province had procured only 28.4 percent of their contracted grain. In recent press reports from Hebei and Sichuan, the provincial governments, concerned with the peasants' lack of enthusiasm for grain production, announced plans to raise the procurement prices or to reinstitute grain production quotas this year.

Party conservatives, who generally oppose Deng's pragmatic reforms, have recently used the press to pinpoint declining state control in grain production as a threat to central planning. The strongest attack came at the Party Delegates Conference in September, where Politburo member Chen Yun used statistics on falling grain figures to attack the rapid pace of

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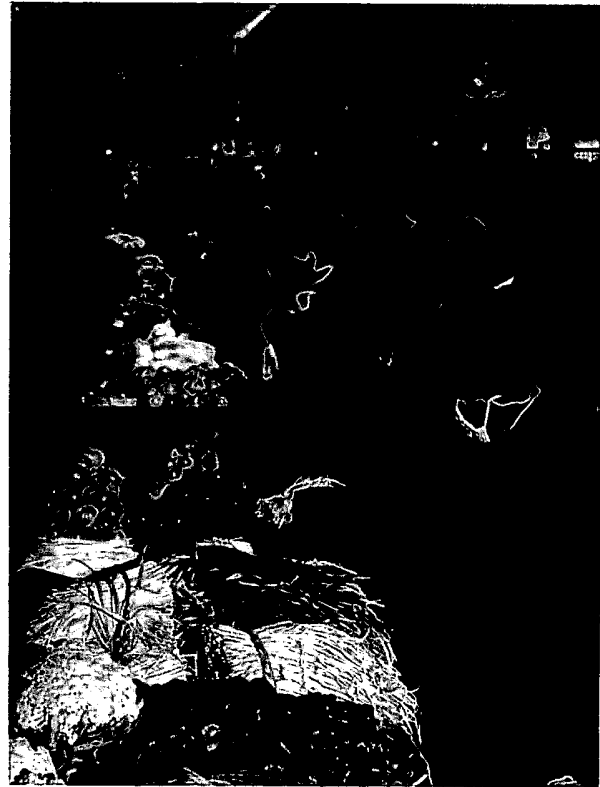
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Poultry production experienced rapid growth during 1985. [redacted]

A more efficient and profit-conscious agricultural economy is pushing surplus labor out of farm production and into other types of work. By mid-1985, according to Chinese press reports, government-sponsored programs to develop rural industries had led 60 million peasants to leave farming to engage in businesses such as restaurants, service shops, repair businesses, and transport firms.² Recent US Embassy reporting indicates that the rate of growth of rural industry during 1985 will be higher than in previous years. The Chinese press reported that the number of restaurants in China's rural areas has increased by more than 13 times in the last seven years. The fastest growth, however, has been in the private transport sector. According to Xinhua, the number of private transport businesses increased by more than 40 percent in the first six months of 1985, accounting for 40 percent of the total goods transported in China on a ton-per-kilometer basis. [redacted]

China's planners may be somewhat disappointed by the move to light industrial production and service industries. In various official speeches and press releases, national leaders expressed their belief that peasants leaving farming would initially focus on food



The quality of fresh vegetables available to consumers has vastly improved with reform. [redacted]

processing, a shift that could have bolstered China's agricultural exports. High commodity prices, poor transportation, and inadequate technology and capital, however, apparently made most types of food manufacturing unprofitable. Prepared fruit drinks and beer for domestic consumption were exceptions, as both experienced phenomenal growth in 1985. [redacted]

Rural Credit Problems

The shift to rural industries made rural finance a volatile issue in the early months of the new reforms.³ A US Embassy report noted how the National Rural

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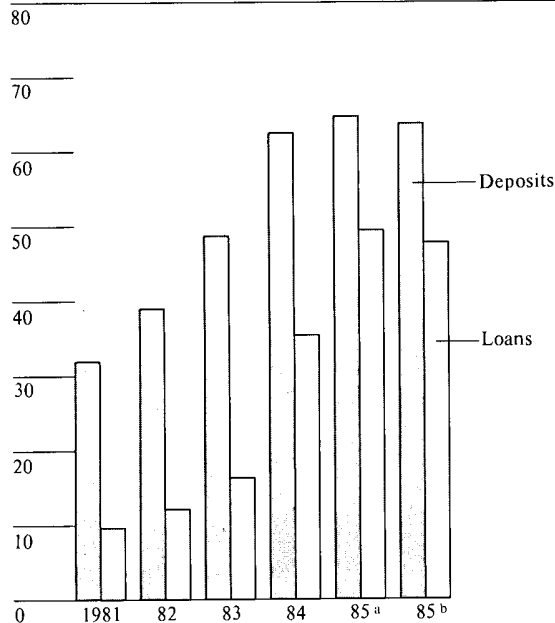
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Figure 3
China: Deposits and Loans of Rural
Credit Cooperative, 1981-85

Billion Yuan

^a First-quarter figure.^b Second-quarter figure.

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Work Conference in December 1984 reaffirmed Beijing's full support for the development of rural industries by offering preferential loans for rural enterprises and income tax exemptions for newly established entrepreneurs. Spurred by the new policies, local bank loans to rural enterprises during the first quarter of 1985 rose more than three times over the corresponding period in 1984 (see figure 3).

Alarmed by the "irrational" credit explosion, the State Council tightened bank credit in April for all rural enterprises. According to a US Embassy report, the People's Bank policy initially damaged rural entrepreneurs, who had to cut back expansion plans and in some cases return borrowed money so banks

could meet annual loan targets. The shock was short lived, however, as local officials and businessmen turned to popular credit—local stock issues and other types of borrowing—to finance rural businesses. This has allowed for a continuing boom in the development of rural industries, evinced by the fact that, in the first six months of 1985, Chinese rural industrial output was up 50 percent over last year.

Ironically, perhaps, the credit squeeze was felt most by the public sector. Summer grain procurement was affected in some areas during June and July—the peak summer grain harvest months—when local officials in several grain-producing provinces were caught with inadequate funds to fulfill purchase agreements with grain producers. Some localities had to give the peasants temporarily uncashable checks. In all reported cases, however, local officials were eventually able to gather sufficient funds from various local sources to handle summer crop procurement.

The State's Changing Role in Agriculture

One of the most serious setbacks of the new policy's implementation has involved local cadre and their difficulties in adjusting to the new reforms, particularly the reduction and decentralization of national-level involvement in agriculture. Responsibility for procurement, marketing, banking, and other economic decisions is being placed more squarely on the shoulders of local government personnel.

In many ways, however, the reforms conflict with cadre interests. Before reform, the surest route to success in China, economic or otherwise, was through membership in the party. Even lower level cadre were treated with respect by the Chinese populace. But the reforms, with their emphasis on individual responsibility and economic gain, are making the "10,000-yuan households" the new rural heroes. Local press reports suggest that cadre and peasants alike are wondering what the proper role of officials is in rural development. Imprecise guidance from Beijing has contributed to the problem.

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Circulars issued by national leaders to "clarify" policies can be seen as implicit admissions that not all rural cadre agree with the new policies. Some rural officials have openly refused to carry out the reforms, and others, while espousing the new system, have not altered their agricultural programs. Worse yet, some officials have drawn up reform programs that directly violate the policies established in Central Document No. 1. The Chinese press has noted that in these areas the peasants humorously refer to these unsanctioned policy changes as Central Document No. 2. Other rural cadre are too enthusiastic about reform, allowing peasants to go their own way—even turning a blind eye to economic crimes. In a few cases, state authorities have been attacked in the press because of their complicity in illegal operations. Beijing recently announced that it will carry out a rural rectification campaign to provide local-level cadre with more detailed information on the reforms and how they are to be implemented.

The greatest number of peasant complaints deal with overtaxation and other abuses of power by rural officials. Since July, a national and local media campaign to "reduce the burden" on peasants has disclosed some of the problems. According to the national press, some local cadre are pushing their own expansion programs, and recently the number of theaters, gymnasiums, roads, buildings, and other public works projects has skyrocketed. To finance these projects, local cadre have illegally docked funds from procurement checks, increased taxes and tolls, and solicited contributions from peasants. Press reports state that some corrupt cadre have also used public funds to pad their bank accounts or to build themselves new homes. Other local leaders, resentful of those who make money from private activities, set up bureaucratic roadblocks to business entry or tax away the profits of successful businessmen. According to China News Service, in one county of Guangdong Province a peasant has to pay 29 different fees to 11 departments to own a tractor. These fees can add as much as 750 yuan to the cost of owning a tractor, the equivalent of one-third its purchase price.

The Keys to Continued Success

The party guidelines for the Seventh Five-Year Plan for National Economic and Social Development (1986-90), adopted at the party conference on 23 September 1985, established several goals for Chinese agriculture during the next five years. National planners estimate that agriculture will grow by 6 percent annually, and the output of all sectors of the rural economy, including grain production, will increase during the planned period. The per capita consumption levels of rural residents are expected to grow annually by 4 or 5 percent, and more consumer goods and better housing will be provided to ensure a higher standard of living. Resource conservation and product quality in the production of economic goods are being emphasized.

We do not believe this plan will lead to any major changes in Chinese agricultural policies in the coming year, but we anticipate that Beijing will make policy adjustments to fine-tune the present program. Policy-makers will try to slow rural industrial growth by controlling official and popular forms of rural credit. Concerned with the decline in 1985 grain yields, they will also raise grain procurement prices, subsidize peasants for agricultural inputs, or perhaps reinstate quotas for some types of grain to encourage production.

Even if these adjustments are successful, key agricultural problems must be addressed if reform is to prosper:

- A program must be developed that ensures stable and increasing grain output while encouraging other agricultural production.
- Local cadre need to control effectively the growing rural private sector.
- Food-price inflation must be checked without burdening the state budget with increased food subsidies.

Over the short term, we believe Beijing will be able to satisfy its demands for economic control and still offer the incentives peasants need to attain a 6-percent rate of annual growth in agricultural output. After a

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substantial decline in grain output last year, we expect higher grain prices and state directives to stimulate an increase in grain production in 1986. Overall, Beijing's economic fine-tuning will probably bring a greater degree of stability to China's countryside and may help mollify party conservatives who have highlighted falling grain production and the uncontrolled growth of rural industries in their criticism of reform.

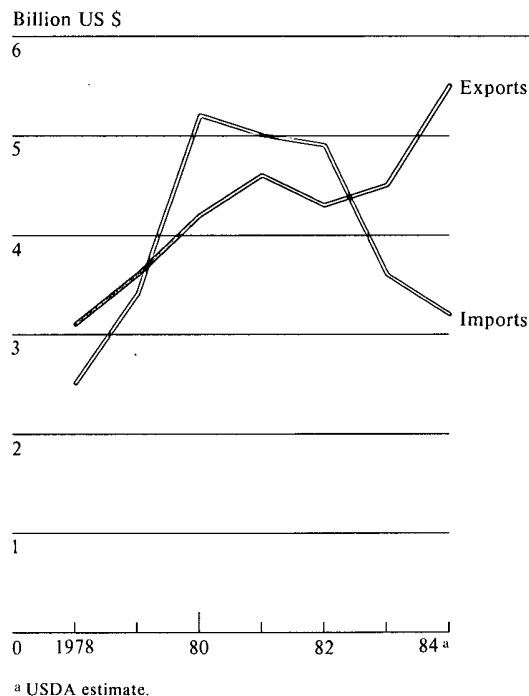
In this regard, the success of the rural program is important for the reformers' larger agenda. Expansion of urban reforms, including price and wage reform, is set for this year. Growth of the urban economy depends in part on continued growth of the rural sector. Perhaps more important, however, the continued success of the agricultural program provides the reform coalition with one of the strongest arguments with which to refute their more conservative colleagues. The reformers must retain the initiative on this issue if they are to contain the opposition and win the time to work through the problems.

Implications for the United States

The agricultural reform program will probably lead to increased Chinese agricultural exports, possibly increasing Chinese competition with US products in some markets. National and provincial agricultural leaders are pushing the export of Chinese agricultural goods, and sales of Chinese corn, soybeans, cotton, and other agricultural commodities have increased as a result (see figure 4). Moreover, until it expands its livestock industry, Beijing will try to export its surplus of coarse grain. Finally, we look for the Chinese, already exporters of fresh and processed fruit and vegetables, to broaden their international markets for these products.

The drop in Chinese agricultural imports will continue this year even though a weather-induced decline in Chinese soybean production will require the purchase of a few shipments of soybeans from other countries, most likely including the United States. Although it is possible China will need US coarse grains to fully develop its livestock industry, we think the Chinese in the near term will try to keep livestock herds within the bounds of domestic feed production. China will be looking to the United States and other Western

Figure 4
China: Farm Trade, 1978-84



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countries for breeding stock, hybrid seeds, and other agricultural technology, but, unless the weather brings an unexpected crop failure, we do not expect China to make any major purchases of US agricultural commodities any time soon.

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